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MINISTRY OF FINANCE

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Report to the Storting (white paper)

The Government Pension Fund 2023

Recommendation of the Ministry of Finance of 31 March 2023, approved by the Council of State on the same day (Government Støre)

1 Executive summary

The Government Pension Fund is owned by the State and comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The purpose of the Fund is stipulated in the Government Pension Fund Act: The savings shall support the funding of pension expenditure under the National Insurance Scheme and facilitate spending of government petroleum revenues reflecting long-term considerations, thus ensuring that the wealth from the petroleum resources benefits both current and future generations. The investment objective of the Government Pension Fund is to achieve the highest possible return, given an acceptable level of risk. Within the scope of this objective, the Fund shall be managed responsibly. A clear financial objective, together with responsible long-term investment management, ensures that the Fund will benefit both current and future generations.

The Ministry of Finance holds the formal responsibility for the management of the Government Pension Fund, and sets the investment framework for the Fund, including requirements regarding risk management, reporting and responsible management. Key choices are endorsed by the Storting, prior to implementation. Norges Bank and Folketrygdfondet conduct the operational management of the GPFG and the GPFN, respectively, in accordance with management mandates stipulated by the Ministry.

The management of the Government Pension Fund shall be as transparent as possible, within the limits set a by proper implementation of the investment strategy. Transparency and broad endorsement serve to ensure that the risks assumed are understood and accepted by the Fund's owners. Thisstrengthens the ability to remain committed to the chosen investment strategy over time, also during periods of significant market downturn.

The market value of the investments in the Government Pension Fund varies with financial market developments. In recent years, the value of the GPFG has increased considerably and returns have been higher than can be expected in the long term. Large government petroleum revenues have contributed to the Fund increasing even in years of sharp market downturn. Such was also the case in 2022. In addition, the depreciation of the Norwegian krone contributed, when considered in isolation, to a higher Fund value in 2022 measured in NOK. While the return was -14.1 percent, corresponding to NOK -1,637 billion, revenues from petroleum activities and the depreciation of the Norwegian krone contributed to an overall increase of NOK 89 billion in the Fund value last year. However, in the years ahead we must be prepared for the Fund value to not increase at the same rate as has been registered so far, and for a potential decline in Fund value.

The investment management framework for the Government Pension Fund is established by the Government and the Storting, but the Fund is not a policy tool. The financial objective of the Fund strengthens the ability to fund government expenditure. Over time, the GPFG has become an ever more important source of funding for government spending. In recent years, around 20 percent of the fiscal budget has been funded by the GPFG, and the share was even higher in 2020 and 2021 due to extraordinary measures during the coronavirus pandemic.

The fiscal policy guidelines require annual withdrawals from the GPFG to over time correspond to the expected real rate of return on the Fund capital; estimated at 3 percent. The guidelines further stipulate that petroleum revenue spending in any given year shall be adapted to the economic situation. This implies that spending should be less than the expected real rate of return during periods of economic upturn, but also that spending may be higher in times of economic setback. However, running persistently large fiscal deficits would impair the sustainability of public finances in the long-term.

Large increases in the value of the GPFG over the last two decades have offered scope for a significant increase in the spending of Fund income. As the Norwegian welfare state has increasingly been funded by transfers from the Fund, public finances have become more vulnerable to international financial market fluctuations.

Investment strategy

The purpose, size, ownership, and other distinctive characteristics of the Fund may give rise to a number of investment opportunities but may also entail certain limitations. The Ministry of Finance is committed to an investment strategy for the GPFG and the GPFN which is professionally acknowledged and tailored to the distinctive characteristics and purpose of the Fund. The strategies have been developed over time, based on professional reviews and recommendations, thorough assessments, and practical experience.

The investment strategy is defined in the management mandates for the GPFG and the GPFN and is reflected in the composition of the benchmark indices. The strategic benchmark indices define a capital allocation between equities and fixed-income securities, and reflect the owner's investment preferences and risk tolerance. The equity share for the GPFG is 70 percent, and

60 percent for the GPFN. In general, investments that offer a potential for higher returns will also entail a higher risk of loss. In other words, there is a trade-off between return and risk. In endorsing the choice of equity share, the Storting has expressed what is an acceptable level of financial risk in the management of the Fund.

A key premise underpinning the investment strategy for the GPFG is that some of the risk associated with securities investments can be reduced by diversification. By diversifying investments across different asset classes and companies in in different geographical areas, the Fund becomes less vulnerable to developments in individual companies, industries, countries, and regions. Over time, a well-diversified portfolio will entail lower risk than a concentrated portfolio. Reduced diversification and restrictions on the Fund's investment opportunities may on the other hand result in higher risk, without a corresponding increase in the expected return.

The benchmark indices have been designed with a view to ensure investment diversification and to facilitate close replication at a low cost. They are also used to measure the investment management performance of Norges Bank and Folketrygdfondet. Within certain defined risk limits, the investment managers may deviate somewhat from the benchmark indices. This is intended both to facilitate cost-effective investment management and to allow for the utilisation of distinctive characteristics of the Funds in order to seek excess return. For the GPFG, there is also some defined scope for investments in unlisted real estate and unlisted renewable energy infrastructure.

The design of the investment strategy is premised on a long investment horizon. The GPFG and the GPFN can withstand more risk than an investor with ongoing payment obligations and consequently a shorter investment horizon. The Funds can weather stock market downturns without having to divest at an unfavourable time. In its report, the Sverdrup Committee (NOU 2022: 12, green paper) has presented simulations of the value of, and return on, a fund with characteristics similar to those of the GPFG (70 percent equities and broad diversification) over the period 1899–2021. This period includes major structural shifts and dramatic geopolitical events, including two world wars. Despite long periods of weak or negative returns, the simulation shows that the real value of NOK 1 invested in 1899 would have been around NOK 545 by end of 2021. This corresponds to an average annual real rate of return of 5.3 percent. Key assumptions underpinning this finding are broad diversification and the ability to remain committed to the chosen investment strategy, even in turbulent times.

The investment strategies for the GPFG and the GPFN are discussed in chapters 2.2 and 4.2 respectively (in Norwegian only).

Investment performance in 2022

Financial markets were characterised by large fluctuations in 2022. Repeated lockdowns in China contributed to bottlenecks in international value chains. Energy prices were high, partly because of Russia's warfare in Ukraine. Together with high demand due to the rapid recovery in the wake of the coronavirus pandemic, this contributed to global inflation rising to the highest levels in several decades. This in turn led to a significant tightening of monetary policy internationally. The US Federal Reserve increased the federal funds rate from close to 0 percent to more than 4 percent during the year. Interest rates on long-term government bonds also increased, contributing to negative returns. For example, the US ten-year rate increased by about 2 percentage points to just over 3.5 percent by yearend.

The global stock market underwent a significant downturn in 2022. The energy sector was the only sector to generate positive returns. Post-pandemic normalisation of demand and higher interest rates contributed to a decline in the technology sector. Other sectors such as real estate and consumer durables also underperformed due to higher interest rates and inflation.

The market value of the GPFG increased by NOK 89 billion in 2022, to NOK 12,429 billion. Revenues from petroleum activities were significantly higher than the non-oil budget deficit, and the Fund received a net transfer from central government of around NOK 1,090 billion. Weak financial market developments led to a return on the Fund of -14.1 percent, corresponding to NOK -1,637 billion, measured in the currency basket of the Fund and before the deduction of investment management costs. When considered in isolation, the depreciation of the Norwegian krone increased the Fund value by NOK 642 billion. However, the NOK exchange rate does not affect the international purchasing power of the Fund. The market value of the GPFN at year-end 2022 was NOK 318 billion, a NOK 15 billion reduction over the course of the year. The return on the GPFN last year was -4.4 percent, measured in NOK and before the deduction of investment management costs.

Norges Bank and Folketrygdfondet seek to achieve the highest possible return, net of costs and given an acceptable level of risk, within the limits stipulated in the mandates from the Ministry of Finance. In 2022, Norges Bank achieved a return on the GPFG that was 0.87 percentage points higher than the return on the benchmark index, while Folketrygdfondet achieved an excess return of 0.71 percentage points in the management of the GPFN. The Ministry emphasises the overall performance achieved in the GPFG and the GPFN over time. The average annual return on the GPFG over the last 20 years has been 0.27 percentage points higher than the return on the benchmark index, while the average excess return on the GPFN has been 0.96 percentage point per year since 2007. The Ministry is satisfied with this performance, given the level of risk assumed. Measured as a proportion of assets under management, investment management costs were 4 basis points (0.04 percent) in the management of the GPFG and 6 basis points in the management of the GPFN last year.

The performance of the GPFG and the GPFN is discussed in chapters 2.4 and 4.4, respectively (in Norwegian only).

Responsible investment

Within the scope of its financial objective, the Government Pension Fund shall be managed responsibly. The mandates for the management of the GPFG and the GPFN are based on the premise that favourable long-term returns depend on sustainable development in economic, environmental, and social terms, in addition to well-functioning, legitimate and efficient markets. Environmental, social and governance considerations therefore form an integral part of the Fund management. The mandates from the Ministry of Finance require Norges Bank and Folketrygdfondet to adopt responsible investment principles in accordance with internationally recognised standards. By advocating long-term value creation and responsible business conduct, the responsible investment practices for the Government Pension Fund are held to further the objective of achieving the highest possible return, given an acceptable level of risk.

The responsible investment framework includes furthering good corporate governance and responsible business conduct principles, as well as contributing to the development of international standards, company dialogue, along with voting in annual general meetings. Norges Bank has, as part of its responsible investment efforts, prepared expectation documents on nine different issues, including, human rights, climate change and anti-corruption. Folketrygdfondet has outlined what it expects from companies on seven different topics. The documents are directed towards the boards of directors at GPFG and GPFN investee companies and are used as, inter alia, a starting point for ownership dialogue.

The Ministry of Finance has adopted Guidelines for Observation and Exclusion of Companies from the GPFG. The guidelines feature both product-based exclusion criteria, which encompass the production of tobacco, cannabis, coal and certain types of weapons , and conduct-based exclusion criteria, which encompass, inter alia, serious, or systematic human rights violations and severe environmental damage. An independent Council on Ethics appointed by the Ministry of Finance makes recommendations on the observation or exclusion of companies, while the Executive Board of Norges Bank makes decisions in such cases. For the coal criterion and the climate criterion, the Bank may decide on observation or exclusion without any prior recommendation from the Council on Ethics. Before exclusion is decided, the Bank shall consider whether other measures may be suited for reducing the risk of continued violation of norms. The Bank shall consider the various tools at its disposal in relation to each other and use these in an integrated manner. Remaining invested and seeking to influence companies to change their conduct can be an effective means of reducing the risk of ethical norm violations. What is the most appropriate tool must be considered by the Bank on a case-by-case basis.

The investments of the Fund attract considerable attention. The investment strategy for the GPFG implies that the Fund is invested in several thousand companies, including in countries and regions with different norms and values. It is neither feasible, nor appropriate, to organise the investment management in such a way that the Fund can never be exposed to unwanted situations. The Sverdrup Committee (NOU 2022: 12 green paper) noted that responsible investment may become more demanding in the years to come and warned against creating expectations that it will be impossible to deliver on.

Responsible investment is a professional field undergoing rapid development. The Ministry of

Finance is committed to ensuring that the responsible investment practices of the Government Pension Fund shall be in line with leading international practice, and aims for the GPFG, as a large, global long-term state-owned fund, to be leading in responsible investment.

The responsible investment of the GPFG and the GPFN is discussed in chapters 2.3 and 4.3, respectively (in Norwegian only).

Follow-up on NOU 2022: 12; The Fund in a changing world

In September 2021, a public committee chaired by Ulf Sverdrup (Director of the Norwegian Institute of International Affairs) was appointed to review how international political and economic developments may affect the GPFG. The Ministry received the Committee's report on 26 September 2022. The report has been circulated for public consultation.

The Committee is of the view that Norway has managed its petroleum resources and the Fund wisely. At the same time, the Fund has benefited from favourable circumstances. However, the Committee expects future international political and economic developments to entail considerable changes, uncertainties and risks that will also affect the GPFG. Trends towards democratic erosion, autocratisation, protectionism, inter-country rivalry and economic decoupling will have implications for economic growth and financial returns, as well as the relationship between politics and economics, along with the overall global risk outlook. The economic centre of gravity is shifting towards emerging markets. Both financial and non-financial risks may increase, and the management of the GPFG may become more demanding.

An important principle underpinning the investment strategy is that financial risk can be reduced by diversifying investments across different asset classes, countries, sectors, and individual companies. Broad geographical diversification makes the Fund less vulnerable to developments in individual countries, smooths out portfolio fluctuations and contributes to a better ratio between expected return and financial risk. In the face of the geopolitical risk outlook, the Committee believes that the main principles behind the investment management model remain the best outset, and that the principle of broad diversification should be retained.

The Committee is not proposing any changes to the investment strategy for the Fund. According to the Committee, any changes to the investment strategy should be thoroughly considered and not impulsive, and the risk must be well understood and accepted by the owner. It is important that the investment strategy is well aligned with the owner's risk tolerance, thereby enabling the owner to retain its commitment to a professionally recommended long-term investment strategy, even when the Fund value is declining.

The Committee makes several recommendations for strengthening the framework for developing the investment strategy and the management of the GPFG. According to the Committee, the Ministry of Finance should formalise systematic reviews of the strategy every few years, as a supplement to the current continuous development of the strategy. The Committee also believes that the Ministry should consider establishing an external expert group, with some element of continuity among the participants, which may provide advice and assessments. Furthermore, the Committee proposes that the Ministry consider whether Norges Bank's mandate should be made somewhat more general, with a focus on stipulating applicable investment management principles. The Committee also emphasises that the Ministry of Finance and Norges Bank need appropriate up-to-date expertise and contingency plans to prevent and manage incidents and crises. The Committee attaches great importance to transparency, risk disclosure and clear communication of the Fund's role as a financial investor.

According to the Committee, the Fund has affected Norway's international relations and plays an increasingly important role in shaping Norway's international position and reputation. The Committee notes that the Fund is not to be used as a foreign policy tool and that caution needs to be exercised to avert any impression that it is being used in such a way. The Committee emphasises that other foreign policy channels are more suitable for promoting Norwegian political interests abroad. Using the Fund as a policy tool would complicate both the foreign policy and the management of the Fund, with a high probability of weakening both areas. At the same time, the Committee notes that foreign policy decisions may affect the Fund, and that decisions in the management of the GPFG may have foreign policy implications even if such decisions are financially motivated. It is also not inconceivable that other countries, whether allied or non-allied, in future will, for various reasons, expect the

GPFG to invest in, or exclude, certain markets or companies.

The Committee notes that the scope for responsible investment may be weakened if an increasing share of financial markets are locatedin states with less democracy, transparency, and freedom of the press. Expectations, ambitions, and requirements need to be considered from the perspective of such a setting. Responsible investment is important for the legitimacy of the Fund, but the Committee notes that it may be a dilemma that measures likely to strengthen the GPFG's reputation in Norway may at the same time weaken the Fund's reputation abroad. Responsible investment activities may be perceived as an attempt at imposing Norwegian values and interests on companies and states. The Committee notes that increased awareness that the Fund may be perceived differently abroad than in Norway is important. The Committee believes that a realistic level of ambition for the ethical framework is called for, and that the ethical consideration of ensuring a favourable return for future generations needs to be carefully balanced against other ethical considerations.

The consultative bodies generally endorse the Committee's assessments, while at the same time highlighting various considerations they believe should be accorded weight in the management of the Fund.

The Ministry notes that the Committee supports the model on which the management of the Fund is based, and is focused on safeguarding the Fund structure. The Committee's analysis and recommendations provide no basis for changing any key principle of the investment strategy for the GPFG at present. The Commission's assessments and analysis, together with comments from the consultative bodies, will be included in the Ministry's ongoing and future work on developing the investment strategy and the investment management.

Against the background of these assessments and Norges Bank's consultative comments, the Ministry has in a letter of 27 March 2023 asked the Bank to examine various aspects of unlisted equities as a basis for the Ministry's further consideration. The Ministry will in this context also consider how the Committee's recommendations on strengthening the framework for the Ministry's and Norges Bank's work on the Fund may be followed up on. In connection therewith, the Ministry will consider, inter alia, how regular reviews of the strategy can be formalised and how relevant insights can best be obtained and utilised, both from internal and external expertise. In an uncertain world, the Ministry and Norges Bank need to be well prepared. This will continue to be emphasised in the future. Communications to the Storting and the public on various aspects of the management of the Fund should also be evolved.

The Commission's report is discussed in more detail in chapter 3.1 (in Norwegian only).

Composition of the fixed-income benchmark for the GPFG

The Ministry has decided that no new markets will, for the time being, be included in the government bond component of the fixed-income benchmark for the GPFG. This to facilitate close index replication and low transaction costs. Assessments as to whether new markets should be included in the government bond component of the fixed-income benchmark will, as for the equity benchmark, be made in the context of broad reviews of the investment strategy for the GPFG.

The fixed-income benchmark is discussed in more detail in chapter 3.2 (in Norwegian only).

Investments in Russia

The Ministry of Finance discussed the GPFG's investments in Russia in The Government Pension Fund 2022 white paper and in the National Budget 2023. After Russia invaded Ukraine on 24 February 2022, the Ministry of Finance decided on 28 February 2022 to freeze all investments in Russia and to withdraw the Fund from the Russian market. The Ministry stipulated that the divestment shall take place in compliance with applicable sanctions and be conducted in a way that safeguards the other interests of the Fund. In a letter of 21 March 2022, the Ministry of Finance requested Norges Bank to revert with advice on a plan for the divestment as soon as the market has been sufficiently normalised. The market for trading in Russian financial instruments is still subject to comprehensive sanctions and has not been normalised as of March 2023. Hence, divestment cannot be executed for the time being.

Review of active management in the GPFN

Since 2010, the Ministry of Finance has reviewed Folketrygdfondet's active management of the GPFN on a regular basis. The purpose of such reviews is, inter alia, to assess investment performance and whether the scope for deviations from the benchmark index should be changed. The reviews are intended to facilitate the continuation of strategies that are profitable in the long term, also in periods of weak performance. In this white paper, the Ministry is presenting a new review.

The Ministry of Finance's mandate for the management of the GPFN allows Folketrygdfondet to deviate from the benchmark index within certain limits. The purpose of such deviations; so-called active management, is to utilise the Fund's distinctive characteristics and advantages to attain cost-effective management and seek excess return over time.

For the period from 2007 to September 2022, Folketrygdfondet has achieved a return that is around NOK 40 billion higher than the return of the benchmark index, while the excess return over the last four years comes to just over NOK 7 billion. Both the equity and the fixed-income management have made positive contributions over time.

The excess return on the Fund's is high, even after adjusting for the risk assumed. The active management of the GPFN improved the ratio between risk and return, compared with the benchmark index.

In recent years, Folketrygdfondet has utilised only a limited part of the scope for permitted deviations from the benchmark index. Folketrygdfondet notes that the Fund's size and active management mean that utilisation will normally be considerably below the permitted level. Situations may nonetheless arise in which Folketrygdfondet would want to considerably expand its tracking error, for example during periods when investors are better paid for taking risk.

The Ministry's assessment is that Folketrygdfondet's active management performance has been good overall, and that the GPFN should continue to be managed with a certain element of active management. Like Folketrygdfondet, the Ministry is of the view that the limits stipulated in the mandate are appropriate and well adapted to the management of the GPFN. The Ministry does not propose any change at the present time.

The review of Folketrygdfondet's active management is discussed in more detail in chapter 4.5 (in Norwegian only).

Large ownership stakes on the Oslo Stock Exchange

In a letter of 13 December 2019, Folketrygdfondet advised to amend the management mandate for of the GPFN, on the basis that the GPFN's ownership stakes in companies listed on the Oslo Stock Exchange over time have become so large that there is a risk of breaching the 15 percent ownership stake limit in Norwegian companies. According to calculations by Folketrygdfondet, it would in the event of a stock market decline of the same magnitude as during the global financial crisis be impossible to rebalance the portfolio without breaching the ownership stake limit. The large ownership stakes also limit Folketrygdfondet's scope for deviating from the benchmark index and thereby to achieve excess returns or reduce portfolio risk.

The Ministry is reviewing various alternatives and has yet to conclude on how the ownership stake issue should be resolved. The Ministry will revert to the Storting when it has completed its examination of the issue.

The issue is discussed in chapter 5.1 (in Norwegian only).

New state-owned investment management unit in Tromsø

In The Government Pension Fund 2022 white paper, it was announced that *"the Government aims to establish a separate unit in Tromsø, which can serve to strengthen central government presence and develop professional investment management centres in northern Norway."* The Standing Committee on Finance and Economic Affairs took note of this and welcomed further details on the matter.

Against this background, the Ministry of Finance appointed a working group to examine the investment universe, management structure and organisational set-up of a new state-owned investment management unit in Tromsø. The terms of reference of the working group were based on the premise that the purpose of *establishing* the unit is to strengthen central government presence and develop professional investment management centres in northern Norway and that the purpose of the *investments* managed by the unit should be to achieve the highest possible return over time, net of costs, given an acceptable level of risk.

The working group is advising against the investments in the new unit becoming part of the

Government Pension Fund, as this would not be in line with the long-standing political consensus that the Fund should not be used to achieve other political objectives than purely financial ones.

Investment management involves economies of scale, and it is inefficient to have multiple investment managers in the same market. The working group notes that the State is already a major investor in both listed and unlisted markets. The working group recommends an investment universe for the new unit that includes unlisted asset classes, arguing that it probably will make it easier to find niches in which the State does not already investing. The working group is of the view that the choice of investment manager must be considered in accordance with the choice of investment universe. In view of its recommendation of an unlisted investment universe, the working group recommends the establishment of a new unit under the Ministry of Trade, Industry and Fisheries, which can be developed by drawing on the unlisted investment expertise that already exists in the established investment managers that form part of this Ministry's policy toolkit, i.e. Investinor, Argentum and Nysnø.

In line with its mandate, the working group also outlines an alternative model with Folketrygdfondet as investment manager. Under such a model, the working group recommends the establishment of a new unit with a separate investment management mandate, modelled on the Government Bond Fund. In this model the unit would be organised under the Ministry of Finance and managed by Folketrygdfondet. Should this model be chosen, the working group notes that the investment universe should be closely aligned with the existing expertise of Folketrygdfondet, and that the new fund should primarily be invested in listed securities or securities closely resembling listed investments.

The Ministry notes that the purpose of *establishing* the new unit is to strengthen central government presence and develop professional investment management centres in northern Norway. The Ministry also takes note of the long-standing political consensus that the Government Pension Fund should not be used in pursuance of any other political objective than financial savings. To introduce regional development or industrial policy priorities in the management of the Government Pension Fund would represent a significant change in the framework for the management of the Fund. Against this background, the Ministry is, like the working group, of the view that the new unit should not be part of the Government Pension Fund.

The Ministry agrees with the working group's assessment that the choice of investment manager is linked to the choice of investment universe. Investment management is normally characterised by economies of scale. Developing parallel state-owned investment management units with the same expertise, operating in the same market, would generally be inefficient. As the State is already a major investor in both listed and unlisted capital markets, it is difficult to define an investment universe that does not overlap with other state-owned investment managers.

The Ministry will consider organising the management of the new unit in Tromsø under Folketrygdfondet, modelled on the Government Bond Fund that was established as a liquidity measure during the financial crisis in 2009 and re-established in 2020 in response to the coronavirus pandemic. Folketrygdfondet has performed well in its management of the Government Bond Fund, in line with the defined objectives. Furthermore, administration of the arrangement has been straightforward and has been carried out with limited resources. The successful implementation of the arrangement needs to be considered in the context that the investment management mandate has been based on the existing investment management expertise of Folketrygdfondet.

With Folketrygdfondet as investment manager, the investment universe for the new unit should be closely aligned with the existing expertise of Folketrygdfondet. Folketrygdfondet primarily invests in listed markets. The Ministry will proceed with specifying an investment universe and examine sub-segments in unlisted and listed markets, including how any overlap with the Government Pension Fund may be addressed. The Ministry will aim to define the investment universe for the new unit so as to avoid any overlap with the investment management resources and policy tools organised under the Ministry of Trade, Industry and Fisheries. Parallel state-owned investment management units should not be developed, and a prerequisite for using Folketrygdfondet as investment manager is that Folketrygdfondet will be able to build on its existing expertise. In taking this forward, the Ministry will maintain a dialogue with, inter alia, Folketrygdfondet.

The establishment of a new state-owned investment management unit in Tromsø is discussed in more detail in chapter 6 (in Norwegian only).